



الوكالة الإسلامية الدولية للتصنيف
Islamic International Rating Agency

3rd Islamic Banks and Financial Institutions Conference

10-11 March 2008, Damascus

Organized by Al Salam Conferences

“Shari’a Compliance in Islamic Financial Institutions”

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Shari'a compliance is, in our opinion, a commitment to adopt the spirit of Shari'a in all aspects of business, as opposed to mere conformance to the forms. The commitment stems from an inner belief that Shari'a is a set of laws given by the Divine Wisdom and therefore it has the potential for the greater benefit of the individuals as well as the society at large.

The fundamental characteristics of a Shari'a compliant product are found in the prohibition of Riba, the elimination of Gharar, Jahala and Gambling, the implementation of profit sharing, the consideration of moral values, and the obligatory share of the poor in the wealth of the rich (Zakat).

Islamic investors pursue objective of preservation of capital and a market related return on their investment. These objectives are similar to their conventional counterparts. Additionally Islamic investors also seek to ensure that the income earned on their investments is through Shari'a compliant modes only. The risk and return parameters can be evaluated by the financial analysis provided by credit rating of issuers/issues. Similarly an evaluation of Shari'a compliance should also be provided.

Shari'a compliance has to be dynamic. Shari'a does not close the doors for new thinking and new interpretations of the core Islamic principles. It therefore follows that IFIs should create a structure that facilitates and encourages a steady flow of new business ideas from leaders in business to those who understand Shari'a. The ideas would then get a shape and form to be put into practice. The practical application in many instances may encounter obstacles of legal or commercial nature. Such difficulties will again have to be debated to find a corrective course and so on the process of Shari'a compliance will continue with all its dynamism, innovation, creativity and continuous progress.

Shari'a non-compliance or a minimal or casual approach to Shari'a compliance may expose an IFI to several risks. The prominent being erosion of faith of Islamic investors in IFIs, leading to withdrawal of deposits / investments creating serious liquidity and solvency issues for the IFIs.

A strict control over documentation is required to conform to Shari'a requirements while executing the transactions. A wrong sequence in execution can render a transaction non Shari'a compliant and the resultant income will not be allowed (it has to go to charity).

Shari'a approval is generally obtained at the initiation of a product or a scheme. It is important to ensure that the product / scheme remains

Shari'a compliant through out. This could be achieved by having robust Shari'a control procedures, processes and personnel.

The Shari'a audit is usually entrusted to Shari'a Supervisory Board (SSB) and a short report from SSB is usually produced annually. However, the SSB being responsible for approving all transactions and then giving a audit certificate on its own work raises the questions of impartiality and conflict.

It is logical that all IFIs will not commit the same level of resources for Shari'a compliance and will therefore have different level of exposure to Shari'a compliance. An independent rating by a rating agency will assess the level of compliance thus providing a tool to management to mitigate these risks.

The Investors and depositors – This group of people, in our opinion, will be definitely interested because their reasons for coming to an IFI is that they have already made a decision to conduct their financial affairs in a Shari'a compliant manner and would therefore like to be assured that the IFI is not only making a claim to be Shari'a compliant but has also sought an independent 3rd party opinion on its level of compliance to give the confidence that the IFI is not merely paying lip service to compliance.

The regulators – This group will be interested in this information because in most jurisdictions, the IFIs are granted a separate license from that of conventional institutions and their licenses are given with certain conditions requiring Shari'a compliance. Therefore the information about the level of Shari'a compliance will be of interest to them to give them comfort that the IFI is conforming to Shari'a requirements on its own.

Management will be interested in finding through an independent source, the strength of its internal systems and procedures of Shari'a compliance. Any weaknesses reported will provide an opportunity to strengthen such area to minimize the possibility of non-compliance.

The SQR methodology has been developed jointly by eminent Shari'a scholars and rating analysts. The methodology has a comprehensive evaluation system which is applied consistently. The Rating Committee is chosen very carefully to ensure impartiality and independence.

The assessment is based on a combination of steps involving seeking information, examining documents and due-diligence meetings. The emphasis is on assessing both the quantitative and qualitative efforts of the management to ensure Shari'a compliance. The experience of looking

at several institutions provides a reliable assessment of level of compliance.

All institutions are assessed and evaluated for each one of the detailed criterion to arrive at an overall level of rating. The criteria have been carefully determined by prominent Shari'a scholars to ensure that all aspects of Shari'a compliance are covered by the analysis.

The final rating therefore provides a credible assessment on a pre-determined scale which allows the market to compare different institutions on the level of compliance.